

**The Process for Notifying Taxpayers
Regarding Their Elections to File As Small
Business Corporations Should Be Improved**

September 2003

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 26, 2003

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

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FROM: Gordon C. Milbourn III
Assistant Inspector General for Audit (Small Business and
Corporate Programs)

SUBJECT: Final Audit Report - The Process for Notifying Taxpayers
Regarding Their Elections to File As Small Business
Corporations Should Be Improved (Audit # 200330002)

This report presents the results of our review of the process for notifying taxpayers regarding their elections to file as small business corporations. The audit was performed to provide information regarding the effectiveness of the election notification process and to contribute additional information to the Internal Revenue Service (IRS) task force that is working on related issues.

In summary, more needs to be done to improve the IRS election notification process:

- The IRS has no assurance that taxpayers are being notified whether their elections were accepted or denied.
- The IRS is not fully educating first-time filers of small business corporate returns on how to comply with tax laws and obtain available relief.
- The IRS' ability to resolve unprocessable small business corporate returns is inhibited by a new processing procedure.

As a result, the IRS cannot reasonably ensure that approximately 604,000 taxpayers (over a 5-year period) have been notified of the acceptance or denial of their elections. Unclear instructions regarding the filing of elections and related relief provisions may prevent taxpayers from making elections and obtaining the tax benefits of filing a small business corporate return.

Accordingly, we recommended that the Director, Customer Account Services, Small Business/Self-Employed Division, improve controls and revise procedures to ensure that all taxpayers who submit elections are notified as to the status of their elections. We also recommended that notification letters be clarified and instructions improved to better inform taxpayers that their elections were acknowledged, accepted, denied, or revoked and to provide clear instructions regarding compliance with IRS tax laws and relief provisions relating to elections. Finally, we recommended that the Director revise procedures to allow taxpayers time to respond to letters requesting information needed for processing elections.

Management's Response: Management's response was due on September 22, 2003. As of September 24, 2003, management had not responded to the draft report.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Parker F. Pearson, Director (Small Business Compliance), at (410) 962-9637.

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Background

Business entities that wish the Internal Revenue Service (IRS) to consider them small business corporations so they can file a United States (U.S.) Income Tax Return for an S Corporation (Form 1120S) must first file an Election by a Small Business Corporation (Form 2553). The IRS evaluates the election and notifies the taxpayer either that it has been accepted and when it will take effect, or that it has been denied. The IRS' Cincinnati, Ohio, and Ogden, Utah, Campuses¹ are responsible for processing elections and notifying taxpayers of their acceptance or denial.

The major advantages of filing as a small business corporation are, generally, that the small business pays no corporate tax and that profits or losses are passed through to the shareholders to be reported on their individual income tax returns. In contrast, a regular corporation that files a U.S. Corporation Income Tax Return (Form 1120) pays corporate tax on its profits, and its shareholders cannot claim corporate losses on their individual returns. According to the IRS, S Corporations (also known as small business corporations) currently represent more than one-half of all corporate entities filing tax returns.

In a recent Treasury Inspector General for Tax Administration report,² we indicated that the election notification process may be one of the factors that is hampering first-time filers from filing their Forms 1120S. The IRS' response to the report included the formation of a multifunctional task force that is in the process of initiating many actions to address the findings.

We conducted this review to provide information regarding the effectiveness of the election notification process and to contribute additional information to the IRS task force that is working on related issues. We performed the audit at the Brookhaven IRS Campus from February through June 2003. Our audit work included a review of transactions for the

¹ The campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

² *The Internal Revenue Service Needs to Simplify Filing Requirements and Clarify Processing Procedures for Small Business Corporate Returns* (Reference Number 2002-30-186, dated September 2002).

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The Internal Revenue Service Has No Assurance That Taxpayers Are Being Notified Whether Their Elections Were Accepted or Denied

Cincinnati and Ogden IRS Campuses and discussions with staff from the offices of Compliance Services and Customer Account Services, Small Business/Self-Employed (SB/SE) Division, in New Carrollton, Maryland. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Currently, the IRS cannot ensure that all taxpayers who submit elections to file Form 1120S are notified of the acceptance or denial of their elections. This primarily occurs because:

- The IRS does not currently maintain records that show all small business taxpayers who submit elections and the specific notifications that are sent to these taxpayers to inform them that their elections have been accepted or denied, or that the IRS needs additional information.
- Information relating to taxpayer notification is not always maintained as a permanent record.

The time period between submitting an election and filing the initial Form 1120S can be greater than 1 year.³ This time gap is a key reason why there is a need for a permanent record of notices and letters. A permanent record would enable the IRS to effectively ensure that it is notifying taxpayers of the status of their elections.

Recordkeeping issues that need to be addressed

- The IRS records only the volume of elections received and notices/letters sent each week and does not identify specific taxpayers.
- It is difficult to determine whether the letters pertain to Form 1120S election issues because the letters are used for multiple purposes. For example, Form 8832, Entity Classification Election Accepted or S Corporation Election (F2553) Acknowledged/Accepted

³ For example, an election to file a Form 1120S for Tax Year (TY) 2003 was required to be filed by March 15, 2003, or prior, and the due date of the TY 2003 Form 1120S is March 15, 2004.

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(Letter 385 C, referred to as 385 C letter) is used for Form 1120S as well as the unrelated Entity Classification Election (Form 8832).⁴

- Information about notices and letters issued regarding the acceptance or denial of elections is not always available because it is maintained only a short time and then dropped from the IRS online computer system.

The General Accounting Office's *Standards for Internal Controls in the Federal Government* state that internal controls and all transactions need to be clearly documented and the documentation should be readily available for examination. All documentation and records should be properly managed and maintained.

Because the current record keeping system is not adequate, the IRS cannot reasonably ensure that approximately 604,000 taxpayers, over a 5-year period, have been notified regarding the acceptance or denial of their elections.⁵ There is an increased risk that taxpayers will continue to file Forms 1120S without accepted elections. Also, taxpayers will be burdened with additional and unnecessary correspondence to substantiate accepted elections because the IRS requests them to send copies of acceptance letters that should be a part of the IRS records.

⁴ Over the 5-year period (1998 - 2002), the total volume of 385 C letters showing acknowledgment or acceptance of Forms 8832 and 2553 totaled approximately 234,000, and the volume of S Corporation Election (F2553) Rejected/Revoked (Letter 326 C, referred to as 326 C letter) showing denial and revocation of Form 1120S elections totaled approximately 30,000. Because these letters are used for multiple purposes and IRS records do not show the purpose of the letters, there is no way to determine which of these letters involved acknowledgment/acceptance/denial/revocation of Form 1120S elections.

⁵ For details, see Appendix IV.

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Recommendations

The Director, Customer Account Services, SB/SE Division, should:

1. Revise the Internal Revenue Manual (IRM) to be more specific as to the controls over elections received by the IRS and the required record keeping to ensure that all taxpayers who submit elections are notified of the status of their elections. A management information system should be developed to enable the IRS to have a permanent record of all taxpayers who submitted elections and the specific types of notification sent to them regarding the status of their elections.

Management's Response: Management's response was due on September 22, 2003. As of September 24, 2003, management had not responded to the draft report.

2. Revise the format of the various letters⁶ related to elections to be more specific and to limit their use. Letters should be created solely for Forms 2553, and additional letters should be created specifically for Forms 8832. Also, separate letters should be created to inform taxpayers if their elections were acknowledged, accepted, denied, or revoked.

**The Internal Revenue Service Is
Not Fully Educating First-Time
Filers of Small Business
Corporate Returns on How to
Comply With Tax Laws and
Obtain Available Relief**

Part of the SB/SE Division's mission is to educate and inform small business taxpayers and their representatives about their tax obligations and to develop educational products and services to help these taxpayers understand and comply with tax laws.

Based on our review of the IRS tax returns and instructions, we determined that the IRS is not fully educating first-time filers of small business corporate returns regarding

⁶ The 3 letters are: 326 C letter; 385 C letter; and the Form 8832, Entity Classification Election Rejection/Denial, or S Corporation Return Incomplete for Processing: Form 1120S (Letter 429 C, referred to as 429 C letter).

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compliance with the tax laws and relief provisions for elections.⁷ Specifically, we found that:

- Instructions to taxpayers for both Forms 1120S and 2553 do not clearly provide guidance on how to file their initial Forms 1120S when the IRS did not notify them that their elections had been granted. Also, there were no instructions on how shareholders should proceed with the filing of their related U.S. Individual Income Tax Returns (Form 1040).
- Instructions for Forms 1120S and 2553⁸ do not clearly indicate that taxpayers should have evidence of IRS notification that their elections were accepted before filing their Forms 1120S. Instead, if they were not notified, taxpayers are left to decide whether their elections were granted.
- IRS instructions provide no guidance regarding the acceptable proof of filing for elections that were faxed to the IRS. Current instructions for Form 2553 provide for faxing the form to the Cincinnati or Ogden IRS Campus. However, no mention is made of the proof needed to substantiate that faxed elections were timely made.⁹
- Form 2553 election instructions do not contain clear and concise information about relief provisions. These

⁷ Over the years, the IRS has provided relief to taxpayers by enacting revenue procedures (Rev. Proc.) that provide taxpayers with the legal requirements they must follow for the IRS to consider whether their late elections or inadvertent invalid elections can be treated as timely filed.

⁸ IRS instructions that are considered unclear include the following: “Do not file Form 1120S for any tax year before the year the election takes effect. If the corporation is filing the required Form 1120, U.S. Corporation Income Tax Return, or any other applicable tax return, continue filing it until the election takes effect.”

⁹ IRS instructions to taxpayers for Form 2553 indicate under the heading Acceptance or Nonacceptance of Election (page 2) that, “If the IRS questions whether Form 2553 was filed, an acceptable proof of filing is (a) certified or registered mail receipt (timely postmarked) from the U.S. Postal Service, or its equivalent from a designated private delivery service (see Notice 2002-62, 2002-39, I.R.B. 574 (or its successor)); (b) Form 2553 with accepted stamp; (c) Form 2553 with stamped IRS received date; or (d) IRS letter stating that Form 2553 has been accepted.”

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instructions contain the references “Rev. Proc. 2002-1, 2002-1 I.R.B. 1 (or its successor),” and “Rev. Proc. 98-55” without explaining their content. Also, the instructions cite user fees without providing dollar amounts and instruct taxpayers to obtain Regulations 1.1362-6(b)(3)(iii) (how to obtain relief for an inadvertent invalid election when shareholders did not file timely consents). The instructions are confusing, contain jargon, and do not provide information that is easy for taxpayers to understand to obtain needed relief. See Appendix V for the complete relief instructions.

- Letters sent to taxpayers when there was no record of an election do not always contain the necessary information about the shareholders’ need to file amended individual income tax returns. A review of available Form 8832, Entity Classification Election Rejection/Denial, or S Corporation Return Incomplete for Processing: Form 1120S (Letter 429 C, referred to as 429 C letter) sent to taxpayers showed that in 36.6 percent¹⁰ of the cases, small business taxpayers were not informed that shareholders should file amended individual returns when they reported Form 1120S gains or losses, and they did not have timely elections filed. These cases involve gains reported in the amount of \$2.3 million and losses of approximately \$32,000.

Unclear instructions regarding the filing of elections and related relief provisions can result in:

- Taxpayers filing small business tax returns without timely filed elections.
- Taxpayers being prevented from substantiating that a faxed election was timely made.

¹⁰ From the 215 cases sampled, 145 cases (67.4 percent) showed evidence that 429 C letters were sent to small business taxpayers. Of the 145 cases, we identified 71 that had sufficient information to determine whether the shareholders’ information was included. In 26 (36.6 percent) of the 71 cases, the 429 C letters did not provide information regarding the shareholders’ responsibilities for amending their Forms 1040 for the years involved.

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- Taxpayers not obtaining relief to which they may be entitled.
- Potential double taxation on gains if small business taxpayers, without filed elections, are not informed of the need to have shareholders file amended individual income tax returns when gains were reported on their unprocessable Forms 1120S.

Recommendations

The Director, Customer Account Services, SB/SE Division, should:

3. Provide specific instructions to taxpayers regarding the steps to take if they were not notified that their elections were accepted or rejected.
4. Determine the acceptable level of proof to substantiate timely faxed elections. The Director should also develop instructions for taxpayers and revise IRM instructions to describe the acceptable level of proof for timely faxed elections.
5. Eliminate jargon and clarify instructions for Forms 2553 and 1120S regarding how to obtain needed relief.
6. Revise procedures to ensure that the shareholders' responsibility for filing amended individual income tax returns is printed on the 429 C letter.

A New Processing Procedure Inhibits the Internal Revenue Service's Ability to Resolve Unprocessable Small Business Corporate Returns

The 429 C letter requests that taxpayers provide additional information to enable the IRS to process Forms 1120S. The taxpayers generally are asked to provide this information within 30 days from the date of the letter.

Instead of waiting the 30 days for the taxpayers to reply to the initial correspondence, the IRS revised its procedures to treat these unprocessable returns as though no reply will be received and began to convert the originally filed Forms 1120S to Forms 1120. As a result of this revision, there is an increased risk that the IRS will lose control of the taxpayers' replies or will ignore taxpayers' requests to resolve unprocessable Forms 1120S.

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The IRS explained the revision to the procedures as follows:

These procedures allow the unpostable tax returns to be sent to the rejects section prior to the normal suspense time. Historically, only 25 percent of the taxpayers ever respond to the Service's [IRS'] correspondence. The amount of time required to process these unpostable tax returns to the rejects section approximates the amount of time given to taxpayers to respond to the Service's correspondence. Taxpayers are not harmed by these deviations.

These revisions appear questionable and potentially harmful to taxpayers because:

- Taxpayers were not given sufficient time to respond to the 429 C letters. In a limited test of 30 cases, we found that, in 17 cases, the IRS converted the unprocessable Form 1120S to a Form 1120 before the taxpayer could reply with verification of a timely filed election. In these 17 cases, 8 were converted before the IRS sent the 429 C letter and 9 were converted within 14 days of the letter being sent. The 429 C letter generally indicates that taxpayers have 30 days to reply.
- In some cases, there was no indication of a tax return being processed. In 8 (3.7 percent) of the 215 cases reviewed, there was no record of any tax return in the intended tax period, even though there were instructions to renumber the Forms 1120S filed by the taxpayers.¹¹
- The IRS task force is considering including information regarding relief provisions in the 429 C letter, which may increase the response rate.
- Lost returns and taxpayer information can cause additional IRS/taxpayer correspondence and embarrassment to the IRS. Not associating taxpayers' replies could also impede resolution of the unpostable condition and prevent relief to these taxpayers.

¹¹ Based on a review of IRS Master File (the IRS database that stores various types of taxpayer account information) transcripts dated April and May 2003.

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Recommendation

The Director, Customer Account Services, SB/SE Division, should:

7. Revise the IRM and reinstate suspense procedures to allow time for taxpayers to respond to 429 C letters.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective was to evaluate the Internal Revenue Service (IRS) notification process for taxpayers who filed elections to be treated as small business corporations. To accomplish this objective, we:

- I. Identified problems and trends in the notification process for the filing of Elections by a Small Business Corporation (Form 2553).
 - A. Analyzed statistics for 5 consecutive calendar years (1998 - 2002). We analyzed the volume of Forms 2553 filed, the volume of notices sent to taxpayers, the volume of United States (U.S.) Income Tax Returns for an S Corporation (Form 1120S) that could not be processed to the IRS computerized records of tax accounts (unpostables), and the volume of letters related to the acceptance and rejection of elections.
 - B. Determined whether any problems and solutions were identified by the National Taxpayer Advocate concerning the election notification process.
 - C. Reviewed the legal requirements for filing Forms 2553 and 1120S. We reviewed instructions to taxpayers for filing elections to determine whether instructions were clear, complete, and easy to understand.
- II. Determined whether policies and procedures were established to ensure that the IRS notified small business taxpayers that their elections were accepted or rejected.
 - A. Reviewed IRS written instructions to determine the required procedures in the election notification process.
 - B. Held discussions with national and local management officials regarding any actions taken or contemplated by the task force, accounting for Form 2553 elections, the types of notification, and any IRS procedural changes that affected the election notification process.
- III. Determined whether required letters were sent to taxpayers to notify them that the IRS had no record of an election on file and could not process their initial Forms 1120S.
 - A. Selected and reviewed a statistical sample of 215 taxpayer accounts to determine if the IRS notified the taxpayers that their returns could not be processed. We used attribute sampling at a 95 percent confidence level and an expected error rate not over 10 percent, with a precision level of +/- 4 percent. We used a computer extract to determine the volume (71,931) of unprocessable small business corporate returns (Unpostable Code 310 with Reason Codes 2, 4, 5, and 6, which

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relate primarily to Forms 1120S) that were resolved with an Unpostable Resolution Code 8 (URC)¹ for Calendar Year 2002. We then identified the 49,999 returns for tax period 2001 that were worked by the Cincinnati, Ohio, and Ogden, Utah, IRS Campuses.² We used the 49,999 population to select the statistically valid sample of 215 cases.

- B. Reviewed IRS records for each of the 215 cases in our sample to determine whether the required Form 8832, Entity Classification Election Rejection/Denial, or S Corporation Return Incomplete for Processing: Form 1120S (Letter 429 C, referred to as 429 C letter) was sent to taxpayers when required, prescribed procedures ensured that taxpayers were allowed sufficient time to respond to the 429 C letters, Forms 1120S were processed to accounts, and notices were sent to taxpayers.
- C. Analyzed information gathered to determine if there were any trends or patterns to indicate that the IRS needed to provide clearer instructions to taxpayers to facilitate the filing of their initial Forms 1120S.

¹ Unpostable Code 310 is generated when the filing requirements of the U.S. Corporation Income Tax Return (Form 1120) or Form 1120S do not match the information in IRS computerized files. URC 8 removes the record from the Submission Processing Unpostable Master File of taxpayer accounts.

² Because the Cincinnati and Ogden IRS Campuses now process all of the business tax returns, we selected our sample from those two campuses. The campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner C
Deputy Commissioner for Services and Enforcement SE
Commissioner, Wage and Investment Division SE:W
Acting Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Wage and Investment Division SE:W
Director, Compliance, Small Business/Self-Employed Division SE:S:C
Director, Customer Account Services, Small Business/Self-Employed Division SE:S:CAS
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Director, Communications and Liaison, Small Business/Self-Employed Division SE:S:MS:CL
Director, Tax Forms and Publications, Wage and Investment Division SE:W:CAR:MP:T
Chief Counsel CC
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Audit Liaisons: Commissioner, Small Business/Self-Employed Division SE:S

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

Taxpayer Burden – Potential; 604,000 taxpayer accounts affected (see page 2).

Methodology Used to Measure the Reported Benefit:

Internal Revenue Service (IRS) records showed that, during the last 5 calendar years (1998 - 2002), the IRS received from taxpayers approximately 2.6 million elections to be treated as small business corporations. During the same 5 years, approximately 2.1 million taxpayers received notices that they could file a United States Income Tax Return for an S Corporation (Form 1120S). However, less than 13,000 taxpayers received notices that their requests for elections had been denied, and IRS records of notices to taxpayers do not indicate how the other 604,000 accounts were resolved. The IRS has no assurance that these taxpayers received notices informing them that their elections were accepted or denied. The computation is as follows:

CALENDAR YEARS 1998 - 2002

Elections Received (Election by a Small Business Corporation (Form 2553))		2,634,940
Taxpayers Informed by Notices ¹ That:		
Elections Accepted:	2,018,138	
Elections Denied:	<u>12,918</u>	
Total Notifications by Notices:		<u>2,031,056</u>
Volume of Taxpayers Who May Not Have Been Notified That Their Elections Were Accepted or Denied: ²		603,884

¹ The IRS uses computerized notices generated from its Master File (the IRS database that stores various types of taxpayer account information). These notices inform taxpayers whether their elections have been accepted or rejected.

² Over the 5-year period (1998 - 2002), the total volume of Form 8832, Entity Classification Election Accepted or S Corporation Election (F2553) Acknowledged/Accepted (Letter 385 C) showing acknowledgment or acceptance of Entity Classification Election (Form 8832) and Form 2553 totaled approximately 234,000, and the volume of S Corporation Election (F2553) Rejected/Revoked (Letter 326 C) showing denial and revocation of Form 1120S elections totaled approximately 30,000. Because these letters are used for multiple purposes and IRS records do not show the purpose of the letters, there is no way to determine which of these letters involved acknowledgment/acceptance/denial/revocation of Form 1120S elections.

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Appendix V

Relief Provisions Cited on Instructions for Form 2553 (Revision December 2002)

Instructions concerning relief provisions appear on page 2 of the Election by a Small Business Corporation (Form 2553) instructions. The instructions are as follows:

To request relief for a late election, the corporation generally must request a private letter ruling and pay a user fee in accordance with Rev. Proc. 2002-1, 2002-1 I.R.B. 1 (or its successor). But if the election is filed within 12 months of its due date and the original due date for filing the corporation's initial Form 1120S has not passed, the ruling and user fee requirements do not apply. To request relief in this case, the taxpayer should write "FILED PURSUANT TO REV. PROC. 98-55" at the top of page 1 of Form 2553, attach a statement explaining the reason for failing to file the election on time, and file Form 2553 as otherwise instructed. See Rev. Proc. 98-55 for more details.

See Regulations section 1.1362-6 (b)(3)(iii) for how to obtain relief for an inadvertent invalid election if the corporation filed a timely election, but one or more shareholders did not file a timely consent.